Dear Mr Cox

Re: Sydney Water follow up submission to IPART discussion paper: Review of method for determining the WACC

Sydney Water appreciated the opportunity to attend the Independent Pricing and Regulatory Tribunal’s (IPART’s) workshop on the weighted average cost of capital (WACC) on 25 March 2013. The workshop provided for constructive engagement, recognising that the current method used to set the WACC is generating outcomes below reasonable expectations. Sydney Water’s additional comments on the WACC review, including an ‘interim’ approach for Hunter Water and the Central Coast councils, are provided below.

Regulatory objectives
The discussion on regulatory objectives highlighted IPART’s desire to set prices in a manner that was consistent with competitive market outcomes. Sydney Water considers that promoting this objective is consistent with:

1. the setting of a WACC that minimises any distortions with efficient capital raising practices, and
2. having final WACC outcomes that are consistent with available data on the returns earned by businesses with similar risk profiles.

Sydney Water considers that promoting these objectives will provide for more robust WACC outcomes over time compared to the ‘new entrant’ regulatory objective. Importantly, applying the new entrant test implies that firms re-finance all debt within a very short time period every four to five years. Such an approach to raising funds is inconsistent with efficient financing practices, and has the potential to distort efficient capital raising practices if the price regulated business chooses to match the ‘regulatory approach’.

Cost of debt
Sydney Water considers that there was broad consensus among participants on the value of moving to a trailing average approach to calculating the cost of debt. While the move to a trailing average approach will involve addressing implementation and transition issues,
the potential benefits to both consumers and regulated business over the longer term are substantial.

It was noted by IPART at the workshop that it could not develop a trailing average approach by May. Sydney Water agrees that it will take some time to develop and implement a robust cost of debt benchmark for use in future price determinations. Sydney Water would welcome the opportunity to work with IPART and other stakeholders in developing a trailing average approach to calculating the cost of debt.

**Cost of equity**

Sydney Water notes that SFG Consulting presented new evidence at the workshop on the cost of equity. While Sydney Water supports IPART’s proactive approach to commissioning work on the cost of equity, it was difficult for workshop participants to provide meaningful comment on the new evidence. It is also noted that this work focussed on the total cost of equity to derive the market risk premium (MRP). Sydney Water considers that for there to be informed input from workshop participants, IPART needs to distribute any new material well in advance of the workshop.

The work done by SFG Consulting does highlight the important information that can be obtained from examining different sources of evidence in determining an appropriate return to equity. Noting the limited ability for Sydney Water to comment on the evidence, the overall theme that total returns to equity have likely remained stable over time does not seem unreasonable. It would be appreciated if all workshop participants could be provided with SFG Consulting’s final report for review and comment.

Sydney Water also agrees with the views raised by participants that it is not possible for IPART to determine a cost of equity without explicit consideration of the equity beta in addition to the risk free rate and MRP. As noted in NERA Economic Consulting’s expert report, one weakness of the capital asset pricing model (CAPM) is that it can underestimate the return on low beta stocks and overstate the return on high beta stocks. IPART should therefore use additional sources of information outside the CAPM to inform its setting of both the MRP and equity beta.

**Interim method for Hunter Water and the Central Coast Councils**

The proposed new methods for determining the WACC cannot be adequately implemented prior to IPART making its final determinations for Hunter Water and the Central Coast councils. The problem here is that IPART’s current method is generating WACC outcomes well below that consistent with its regulatory objectives and the matters listed under section 15 of the *Independent Pricing and Regulatory Tribunal Act 1992*. As such, Sydney Water supports a pragmatic approach to addressing problems with the current approach to setting a WACC for Hunter Water and the Central Coast councils is needed.

The ‘short short’ and ‘long long’ options presented by IPART show an increasing range in possible WACC outcomes over time. The ‘long long’ option remains relatively stable, while the ‘short short’ options falls from about 5.5% to below 4% by March 2013. Sydney Water would not consider that a real-post tax WACC below 4% to be a reasonable outcome for Hunter Water and the Central Coast councils. This indicates that a simple average of the
two approaches is unlikely to yield an appropriate WACC outcome, as the outcomes of the 'short short' approach are well below reasonable expectations.

As outlined at the workshop, the underlying cost of debt and returns to equity for price regulated businesses are likely to have remained relatively stable, despite the impact of the global financial crisis on some market-based parameters. Sydney Water therefore considers that 'long long' option has generated potential WACC outcomes more consistent with available market evidence. Therefore, if IPART decides to choose within the range generated by the two options, Sydney Water considers that it should be closer to the higher end as generated by the 'long long' option for the reasons stated earlier. Given the 'short short' option has produced unrealistic WACC outcomes, there is also a strong argument that the WACC should be based solely on the 'long long' approach.

Thank you for the opportunity to provide a further submission on the setting of the WACC incorporating the discussions and outcomes of the WACC workshop. For further information, the relevant contact is Dr Kris Funston, Manager Competition and Regulation, who may be contacted on telephone (02) 8849 4856.

Yours sincerely

Kevin Young
Managing Director